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Divorce Wars: Tracking Down the Elusive Double Dip

By James W. Kukull CPA, ASA, ABV

Tabloids cover divorces because often readers are prone to becoming engrossed in the sordid details of sensational and acrimonious proceedings. When practitioners are engaged to provide valuation and litigation services in a divorce, they, too, become engrossed in the details but with more serious purpose. Practitioners so engaged consider many factors, such as the history of the business, its earning and dividend paying capacities, the economy, and industry trends.

An essential element in the process of valuing the business is the "normalization" of the earnings stream for owner perks and dividends disguised as salaries. Income-based methods in small business valuations require an adjustment to the owner's salary when it exceeds a "reasonable" amount. A reasonable salary may be established by reference to salaries in the same industry and geographic area. Compensation in excess of the amount determined as reasonable is added back to the unadjusted income stream of the business, resulting in an increased business value. A *double dip* may occur if the higher salary is then used to establish alimony (maintenance) to the other spouse. In the double dip, not only does one spouse pay a higher amount for the business, but he or she also has to pay more in alimony. Because the extra alimony amount usually comes from the business in question, a double-dip adjustment is required to arrive at the fair value of the business.

Recently, I had an opportunity to describe the double dip to a non-accountant. Ever since I explained to my hair stylist that the "Women's Dinner Club" was a Ponzi scheme, she has been curious about what I do for a living. So, she asked, "So Jim, have you been on any interesting cases recently?"

"Well, I was recently asked to calculate the double dip effect," I replied.

"What's that, more than one scoop?" she asked.

Seeing the twinkle in her eyes, and hoping to steer this conversation far away from the rocky shore I saw looming, I asked if she had a piece of paper and pencil handy. She retrieved both from her counter, and I put the example in Exhibit 1 on page 2 together, illustrating the capitalization of earnings method of business valuation and how the double-dip effect arises.

I handed her my example, and she scrunched up her eyes and concentrated on my handiwork.

"So, if I'm reading this right," she said, "the value of the business is lower if you don't make a salary adjustment. If you make a salary adjustment of $100,000, the value of the business increases by $500,000. But then, you used the higher salary to compute alimony, and that increased the alimony amount by $50,000 a year over what it would have been if you had used the same adjusted salary used in valuing the business. That increased the amount of alimony by $250,000."

"Right," I said. As you can see, she is quick on the uptake.

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EXHIBIT 1

Example of Estimated Value Using The Capitalization of Earnings Method

Value without a salary adjustment		
Unadjusted normalized earnings of the business		$ 400,000
Adjustment of actual salary to reasonable salary		
Actual salary	$ 200,000	
Less: Salary used to value the business	200,000	
Excess compensation		
Adjusted normalized earnings of the business		400,000
Divided by the capitalization rate		20.0%
Estimated value of the business without a salary adjustment		$ 2,000,000
Value with a salary adjustment		
Unadjusted normalized earnings of the business		$ 400,000
Adjustment of actual salary to reasonable salary		
Actual salary	$ 200,000	
Less: Salary used to value the business	100,000	
Excess compensation		100,000
Adjusted normalized earnings of the business		500,000
Divided by the capitalization rate		20.0%
Estimated value of the business with a salary adjustment		$ 2,500,000
Increase in the business value due to the salary adjustment		$ 500,000
The "Double Dip"		
Reasonable salary used to value the business	$ 100,000	
Alimony at 50% of salary used to value the business		$ 50,000
Salary used for alimony calculation (the actual salary)	$ 200,000	
Less: 50% of the salary used for alimony		100,000
The annual "double dip" income effect		$ 50,000
Assume alimony is ordered for five years; the total effect is		$ 250,000

"But that doesn't seem fair," she said, "It should be either one or the other, not both. Oh, I get it. That's the double dip."

She was right again. It isn't fair, so to make it fair, the real question is, how much should the value of the business be adjusted to compensate for the increase in the alimony? So, I asked her, "Okay, now that you see what the double dip amount is, how much do you think the value of the business should be adjusted downward to even things up?"

"Well, that seems easy. The value was $2,500,000 after the salary adjustment, and the double dip is $250,000, so I just subtract that from the value and the new value is $2,250,000," she said.

I tactfully offered, "Most people give that same answer, but it's not quite that easy. Remember how we got to the business value in the first place? We calculated an earnings stream and divided it by a capitalization rate."

I could see the light dawning in her mind. "Now I get it," she said, "Instead of subtracting the total amount of the double dip for five years from the calculated value, we should subtract the double-dip amount for one year from the earnings stream to account for the salary change and recalculate the value."

I had to hand it to her. This second try is the other common way people use to calculate the value of the double dip. Taking another piece of paper, I jotted down the

Continued on next page

EXHIBIT 2

Unadjusted normalized earnings of the business		$ 400,000
Add: excess compensation		
Actual amount paid	$ 200,000	
Reasonable compensation	(100,000)	
Excess compensation	100,000	
Less: the "double dip"	(50,000)	
Adjusted excess reasonable compensation		50,000
Adjusted normalized earnings of the business after the "double dip"		450,000
Divided by the capitalization rate		20.0%
Estimated value of the business		$ 2,250,000

example in Exhibit 2 and handed it to her.

I glanced in the mirror to see what she was doing since she was behind me reading my latest offering. She was poking the paper aggressively with the points of her scissors. Maybe I was next?

'Come on, Jim, that's just what I said before, the adjusted value should be $2,250,000 and this proves it."

She had a point (more than one, if you count the scissors). Looking at it in this way, the value was exactly as if you reduced the initial value by the gross amount of the double dip. That is exactly the point at which many people end their analysis. However, a review of the capitalization of earnings methodology shows that this approach is incorrect. So I gave her additional background information. "Perhaps I forgot to mention a couple of things about the single-period capitalization of earnings model we are using," I said. "First, it really comes from what is known as the Gordon Model, which assumes that the earnings of the business will grow at a constant rate for an indefinite period in perpetuity."

"You mean forever?" she asked.

"For the foreseeable future," I said.

"But you said the alimony stays the same and only goes on for five years, not forever," she said. (As I said, pretty quick on the uptake.)

"That's right, and since it lasts only for five years and does not grow, it is not correct to use an alimony adjustment with the capitalization of earnings model in which it is assumed the income stream will continue to grow at a constant rate for an indefinite time into the future. However, there is another problem."

"What's that?" she asked.

"Good old fashioned American income taxes," I replied with vigor. "The person who pays alimony gets to deduct it from

EXHIBIT 3

Computation of Mid-year Discount Factors

Valuation discount rate	=	25.00%
Present value factors	i =	25.00%
(1+i) to the nth power	Year 1 =	125.00%

Formula	Pwr	Factor
	-	100.00%
(1+.2500)	1	125.00%
(1+.2500) times (1+.2500)	2	156.25%
(1+.2500) times (1+.2500) times (1+.2500)	3	195.31%
(1+.2500) times (1+.2500) times (1+.2500) times (1+.2500)	4	244.14%
(1+.2500) times (1+.2500) times (1+.2500) times (1+.2500) times (1+.2500)	5	305.18%

Computation of Discount Factors

Formula for Discount factors

$PV = FV/(1+I)^N$

Where:
PV = present value
FV = future value
I = discount rate
N = the number of periods

Year		Discount Factors
1	1.0000 / 1.2500	0.8000
2	1.0000 / 1.5625	0.6400
3	1.0000 / 1.9531	0.5120
4	1.0000 / 2.4414	0.4096
5	1.0000 / 3.0518	0.3277

Determination of mid-year modification factors
Formula for modification factor
Modification factor = the square root of (1+ discount rate)
1 plus the discount rate = 125.00%

The square root of 1 plus the discount rate = 1.1180

Year	Year End Discount factor		Modification factor		Mid-year Discount Factors
1	0.8000	x	1.1180	=	0.8944
2	0.6400	x	1.1180	=	0.7155
3	0.5120	x	1.1180	=	0.5724
4	0.4096	x	1.1180	=	0.4580
5	0.3277	x	1.1180	=	0.3664

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BV Standards Update

Here's a message from Mike Crain, chair of the AICPA Business Valuation Committee on the status of the proposed business valuation standard.

By the time you read this, another draft of the revised business valuation standard may be exposed. If not, the latest exposure draft is expected to be issued this Summer. As you may know, public exposure of the proposed valuation standard last year resulted in approximately 160 comment letters. A task force of the Business Valuation Committee reviewed all of the comments and had discussions with several practice groups in the AICPA. As a result of the comment letters and discussions, the task force has made changes to the proposed standard.

income, thus reducing their income taxes. So, that spouse is actually out of pocket only the initial amount of the double-dip less the taxes saved".

If we assume an effective tax rate (total income tax divided by adjusted gross income) of 27%, then the double-dip effect is equal to (1 minus the effective tax rate) times the annual double dip (73% x $50,000 = $36,500 per year). If the divorce is in a state with state income taxes, then you have to factor that effective tax rate also.

"Okay," she replied, "I'll take your word for whatever you just said. So all I have to do is just reduce the business earnings stream by the taxes saved to $36,500 not $50,000 and recalculate, right?"

"Not so fast" I said, "You're forgetting perpetuity."

"Well, if you can't use this Gordon Model to get the double dip, how do you do it?"
"It's another income model called multiple period discounting, also called the discounted cash flow method, or DCF for short," I responded. "It is a mathematical formula that calculates the value of a dollar amount now, that you will not receive until some time in the future. Since a dollar now is worth more than a dollar one year from now, (if for no other reason, inflation) then discounting the dollars by a certain rate of return will give you the value now, but you also have to decide on one other thing."

"What's that?" she asked.

"Assuming you were the one receiving the alimony, when would you get paid? Would it be paid all at the end of the year or would you be paid each month?"

"Well it better be paid each month or I'd sic my attorney on him real fast," she said. (No doubt about that.)

To find out the discounted value of the alimony as if you received it each month, you modify the original discount factor to a midyear factor. The easy way to do this is to multiply the original discount factor by the square root of one plus the discount rate. On another piece of paper, I prepared a calculation of the midyear discount factors using a 25% discount rate and handed it to her.

She looked at it closely, and then said, "I think you made a mistake here. You used a 25% rate here, and in the other example you used a 20% rate. They should be the same number or you will always come out with a different value," she said.

Boy, you can't get anything by her. But I knew it wasn't a mistake. So, I explained to her that in the Gordon Model a capitalization rate was used and in the DCF model a discount rate was used. The capitalization rate

EXHIBIT 4

Computation of the Double Dip

Reasonable salary	100,000
Maintenance at 50% of reasonable salary	50,000
Actual maintenance	100,000
The double dip effect for one year	50,000
Effective tax rate	27.00%
Years of maintenance	5
Discount rate	25.00%

Year	Amount	Less: Tax benefit	Net	Mid year discount factor	Present value
1	$ 50,000	(13,500)	$ 36,500	0.8944	$ 32,647
2	50,000	(13,500)	36,500	0.7155	26,117
3	50,000	(13,500)	36,500	0.5724	20,894
4	50,000	(13,500)	36,500	0.4580	16,715
5	50,000	(13,500)	36,500	0.3664	13,372
	$ 250,000	$ (67,500)	$ 182,500		$ 109,745

Original value of the business	$ 2,500,000
Less the present value of the double dip	(109,745)
Adjusted value of the business	$ 2,390,255

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Ponzi Goes Autosurfing

Charles Ponzi seems immortal as we continually learn of schemes patterned after his original scam perpetrated in the 1920s. A Ponzi scheme is a fraud that promises extraordinary investor returns, but pays them with money from new investors rather than revenue actually generated by the business. By appealing to the almost universal human desire for the security offered by money, Ponzi perpetrators often easily persuade their victims that they can make their financial dreams come true. Ponzi's immortality also can be attributed to the ability of his heirs to adapt their schemes to the current business and social climate.

Good old-fashioned Ponzi schemes, however, are still out there. Consider the case of a solo attorney, Michael J. Wing of Tyler, Texas, who pleaded guilty to wire fraud. As reported by *www.law.com*, the federal government alleged that Wing bilked more than $7 million from investors by asserting that he represented unnamed *Fortune 500* companies needing short-term financing. According to Wes Rivers, an Assistant U.S. Attorney prosecuting Wing, the investors' chance to make a quick profit, "had to be hush, hush. . . . It was a billion-dollar transaction, and the company was willing to pay 7% interest for a 30- or 90-day loan." The government alleged that Wing took the money and spent it, but also used some of the money to pay off other investors, the classic Ponzi scheme strategy. Wing could be sentenced up to 20 years in prison, and ordered to pay a fine of up to $250,000 and restitution to his victims.

Affinity Fraud

Small-time swindlers are targeted by federal and state enforcers. Recently, *Business Week online* (March 27, 2006) reported the "upswing" in *affinity fraud,* "schemes that prey on members of ethnic, religious, and social groups." A sense of exclusion from the mainstream society makes these groups susceptible to entrusting their resources to perpetrators who are themselves members of the minority communities. Along with a lack of sophistication and experience in evaluating the trustworthiness of investment advice and opportunities, these groups are enjoying increased affluence resulting from the real estate boom—a combination that has triggered the increasing incidence of affinity fraud swindles, according to law enforcement officials. *Business Week* cites the misfortune of a Cambodian immigrant, Tai Kim, a print shop worker who worked 12-hour shifts, struggling to support his family here and in Cambodia. An "elegant Cambodian-American woman," Seng Tan, offered him a chance to invest in her vitamin and cosmetics company, and promised him a return of $2,500 monthly for life. Some of his friends had invested their money and were getting the promised $2,500 per month. Tai Kim obtained a home-equity loan to invest the $131, 933 requested by the company owner, and for two years he received $2,500 monthly. When the checks stopped, Tan gave many excuses, including a computer glitch and Hurricane Katrina. In fact, however, there was no business. Eventually, federal prosecutors in Boston filed 11 counts of mail fraud against Tan and two associates, alleging that they had "bilked $30 million from hundreds of Cambodian-American investors from Massachusetts to Minnesota." In addition, investigators discovered "checks drawn on a company bank account that had paid for a $38,000 diamond ring and $200,000 for a Las Vegas trip." The three accused deny the charges, according to their lawyers, In response to affinity fraud, securities regulators have increased their investor education outreach to the target groups.

Auto-Surfing Schemes

The Securities Exchange Commission (SEC) has also reached out to alert companies to a relatively new fraud scheme that has been observed. The SEC says that

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is the discount rate of 25% less an estimated growth rate of 5%. This is another common error: using the two rates as if they were interchangeable. I also explained that the correct rate to use to discount the net double-dip alimony amount is the same one used in the DCF method to value the company because the payment of the alimony is subject to the same risks as the business.

"It still seems like apples and oranges," she said.

"Actually it isn't," I tried to explain. "Multiple period discounting can be used to calculate the present value of any stream of cash flows. It is not under the constraint that the cash flows have to grow each period, and the cash flows do not have to go on forever. If you use an appropriate growth rate in the Gordon Model and an appropriate discount rate in the DCF model, you will arrive at exactly the same value by using either model. Think of the Gordon Model as kind of a shorthand way of doing multiple-period discounting by assuming earnings constantly grow for an indefinite period, not a finite period as in multiple period discounting."

She was losing interest. Some accountants do that to people. So I decided to finish a double-dip calculation and handed it to her for comment.

She looked at my final set of numbers and said, "Wow, the adjustment is a lot less than I originally thought when you do it this way."

As usual, she got it exactly right.

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Letters to the Editor

Focus encourages its readers to write letters on consulting services issues and on published articles. Please remember to include your name and telephone and fax numbers. Send your letters by e-mail to *wmoran@aicpa.org*.

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autosurfing "bears the hallmarks of a Ponzi or pyramid scheme. Autosurfing is offered as a way to help companies generate advertising revenues by increasing traffic to their Web sites. According to the SEC, "The premise behind autosurfing is that companies that advertise on the Internet will pay to increase traffic to their Web sites. These companies hire an autosurf firm or 'host,' which in turn pays individual Web surfers to view certain Web sites on an automatically rotating basis. The more sites the individual visits, the more money he or she stands to earn."

Autosurfing sounds easy and risk-free and is therefore appealing. But there is one possible hitch: Some autosurfing programs require their surfers to pay to participate. However, they may not do this at first. Instead when they sign up to autosurf, the firm might assign to them a limited number of sites to visit and pay them accordingly. Once they've made a modest amount of money, the firm might encourage—or require—them to purchases a "membership" so that they can maximize their earnings, promising high—perhaps double or triple digit—returns on their investment, often within days or weeks of their joining. "The more you click; the more you collect" is the line often used to entice "members."

To deceive members into thinking the scheme is legitimate, the fraudsters behind them typically use the classic Ponzi or pyramid scheme strategy of using money from new recruits to pay off early-stage investors. Eventually, however, when the pyramid gets too big, it collapses.

"Be especially leery of opportunities that require you to pay to play," the SEC advises. Consider the following actual case. In mid-February 2006, the Federal Bureau of Investigation (FBI) announced that it was investigating accusations that 12daily.pro, an autosurfing marketing company, was operating a Ponzi scam. Less than two weeks later (February 28, 2006), the SEC announced the filing of securities fraud charges against the operators of www.12dailypro.com, a "paid autosurf program." The SEC alleges that in fact the operators of www.12daily.pro were perpetrating a massive Ponzi scheme which raised more than $50 million from over 300,000 investors worldwide by offering a 44% return on investment in just 12 days. As a result of the SEC's charges, the defendants, Charis Johnson of Charlotte, NC, and her companies, 12daily Pro and LifeClicks, LLC, ceased their solicitation of investors and agreed to a freeze of all their assets and the appointment of a receiver who will take control of the companies' operations.

According to the Commission's complaint, www.12dailypro.com claimed to be a paid autosurf program that allegedly generated advertising revenue by automatically rotating advertised Web sites into a viewer's Internet browser. Advertisers purportedly pay "hosts," which in turn pay their members to view the rotated Web sites. The Commission's complaint alleges that 12daily Pro's sale of membership units constituted the fraudulent and unregistered sale of securities under the federal securities laws.

The SEC also posted to its Web site an investor alert concerning autosurf programs. The alert can be viewed at *www.sec.gov/investor/pubs/autosurf.htm.* Randall R. Lee, Regional Director of the Commission's Pacific Regional Office, said, "Paid autosurf programs have become an enormous industry on the Internet. When these schemes depend on attracting new members in order to pay returns to current members, they are destined to collapse. The promise of guaranteed, double-digit returns in a matter of days should raise a red flag. We urge the public to be aware that paid memberships in these schemes may be a form of investment, and to exercise extreme caution before investing in any get-rich quick scheme."

According to the Commission's complaint, the 12dailypro Web site, recently ranked as the 352nd most heavily trafficked Web site, solicited investors to become "upgraded members" by buying "units" for a "fee" of $6 per unit, with a maximum of 1,000 units. 12dailypro promised to pay each

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upgraded member 12% of his or her membership fee per day for 12 days. Purportedly, at the end of 12 days, the member would have earned a total of 144% of his or her original membership fee, 44% of which would be profit on the membership fee. To receive the promised payment, a member purportedly must view at least 12 Web pages per day during the 12-day period. In fact, the amount of returns that 12dailypro would pay its members depended solely on the amount of each member's investment, not on the amount of Web site-viewing or any other services rendered.

The Commission alleges that the defendants defrauded investors by operating 12dailypro as an almost pure Ponzi scheme: They used new investor monies to pay the promised returns to existing investors in violation of the federal securities laws. The defendants falsely represented that upgraded members' earnings "are financed not only [by] incoming member fees, but also with multiple income streams including advertising, and off-site investments." In fact, at least 95% of 12dailypro's revenues have come from new investments in the form of membership fees from new or existing members. The other "multiple income streams" from advertising revenues or off-site investments touted by the defendants were either negligible or nonexistent. In addition, undisclosed to investors, Johnson had transferred more than $1.9 million in investor funds to her personal bank account since mid-2005.

Johnson and her companies have consented to the entry of a court order that permanently enjoins them from future violations of the antifraud provisions of the federal securities laws, imposes a freeze on their assets, prohibits the destruction of documents, and appoints Thomas F. Lennon as permanent receiver over the assets of 12dailypro and LifeClicks, LLC. The order is subject to approval by United States District Judge Nora M. Manella. Johnson and her companies consented to the order without admitting or denying the allegations in the complaint. The Commission's complaint also seeks repayment of ill-gotten gains and civil money penalties; the amounts to be sought will be determined at a later date.

Johnson denies any wrongdoing , according to *InformationWeek* (3/2/06). Instead, she blames 12dailypro.com's problems on a payment dispute with StormPay, an online Tennessee-based payment service, which is under investigation by state authorities.

Banned from 12dailypro.com's message forum, Johnson started a blog in which she criticized the SEC in a message posted February 27:

> Keep in mind that the SEC never interviewed us, never talked with us, never examined our data, never looked at our bank accounts, and never examined our books before placing this filing. All information came from outside sources, primarily StormPay and an ex-convict seeking media exposure.

InformationWeek identifies the ex-convict as "Barry Minkow, who served seven years in federal prison for a multimillion dollar fraud committed in the 1980s. Minkow, who has written several books, went straight and now is a recognized fraud expert who works with a firm called Fraud Discovery Institute."

FYI . . .

Companies Still Lack Anti-Fraud Protection Plans

Although companies frequently acknowledge the benefits of having a coordinated approach to preventing fraud, many still lack a plan, according to the findings of a poll recently conducted by Deloitte Financial Advisory Services LLP. During a recent Webcast on corporate fraud, approximately 1,200 internal auditors, and financial policy and risk managers were polled on fraud risk issues. The respondents held senior-level positions at companies in the financial services, real estate, technology, life sciences, and health care industries, among others. The respondents represented primarily public companies with assets of as much as $4 billion, down to mid-sized companies.

Almost half of the respondents think their organizations have increased their focus on fraud prevention and detection in the last 12 months. Even so, although 49% said their organizations had a coordinated, comprehensive approach in place, almost 36% said their companies had no such programs.

In addition, 28% of the respondents said their organizations would benefit from a more robust fraud risk assessment. Less than 5% believed that enhanced fraud helplines and whistleblower programs would reduce their organizations' risk of fraud. In a telephone interview, Bruce Gavioli, a partner in Deloitte's FAS Forensic and Disputes practice, pointed out that helplines and whistleblower programs were required in public companies and, generally, respondents thought they were effective. However, most did not think more needed to be done to increase their effectivenss.

The respondents' focus was on other programs for fraud mitigation. Mr. Gavioli said, "Our poll indicates that many companies believe they could be doing more to address the fraud risk problem. If companies are not thinking about fraud in their

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business, chances are someone else is, and fraudsters can have a significant impact on the bottom line and the reputation of the organization."

The Webcast responses of 27 % of the participants revealed that the overall responsibility for the company's anti-fraud program and controls resides with the CFO or the CEO. Less than 15% said this responsibility resides in the audit committee. However, Federal Sentencing Guidelines mandate that the responsibility for these controls rests with the board of directors, not staff.

The responses reported here are based on the Webcast participants' answers to multiple-choice questions. In addition, participants asked questions. The questions numbered about 150, said Mr. Gavioli, but time permitted the Webcast hosts to answer only 65 of them. Deloitte FAS will issue a white paper that presents the poll's findings and implications in more detail.

SOX Whistleblower Protection Restricted to United States

Protection for corporate whistleblowers under the Sarbanes-Oxley Act of 2002 (SOX or Sarbanes-Oxley) does not extend to foreign workers employed by overseas subsidiaries of U.S. companies, according to a ruling by the 1st U.S. Court of Appeals. The first appellate court to rule on SOX whistleblower protections decided that, "If the whistleblower protection provision is given extraterritorial reach . . . it would empower U.S. courts and a U.S. agency [the Department of Labor], to delve into the employment relationship between foreign employers and their foreign employees. . . . We believe if Congress had intended that the whistleblower provisions would apply abroad to foreign entities, it would have said so."

According to Pamela MacLean in *The National Law Journal* (January 18, 2006), Judge Levin H. Campbell, who wrote on behalf of the panel, included the following as factors that mitigate against international application:

- *The Congressional Record* shows that the Senate was concerned with the uneven application of whistleblower protections from state to state, but did not comment on international implications.
- Congress did not allocate funds for overseas investigation, for coordination with the State Department, for interpreters, or for the use of foreign personnel.

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